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IN THE

Supreme Court of the United States

OCTOBER TERM 1931

No. 413.

THE AETNA CASUALTY AND SURETY COMPANY,
Petitioner,

v.

PHOENIX NATIONAL BANK & TRUST COMPANY,
Respondent.

BRIEF FOR RESPONDENT.

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36227.

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BRIEF FOR RESPONDENT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States.

OPINION BELOW.

The opinion below is found in 44 Federal (2nd) 511 (C. C. A. 6th, 1930).

STATEMENT OF FACTS.

Of date November 14, 1923, the petitioner, The Aetna Casualty and Surety Company (hereinafter called "surety company"), executed and delivered to the respondent, Phoenix National Bank & Trust Company (hereinafter called "the bank"), its bond, which

by payment of premiums was continued in force from noon of its date until April 8th, 1926, whereby it agreed with bank to indemnify and hold it harmless from and against any loss sustained by bank "through the payment, whether received over the counter or through the clearing house, or by mail, of forged or raised checks or (genuine) checks bearing forged endorsements, or the establishment of any credit to any customer on the faith of such checks."

From a time prior to May 12th, 1924, the Petroleum Company, a corporation, was a depositor in the bank; and from prior to May 12th, 1924, until August 1st, 1925, one H. D. Fulton was Vice President and Treasurer of said Petroleum Company, and a member of its Board of Directors, and the clerk in sole charge of its books of account, check books, pass books, bank statements and the like, and was entrusted with the duty of preparing checks to be drawn upon its account at the bank. The persons who had authority to sign checks for Petroleum Company were Felix M. Miles, its President, and J. Fred Miles, his brother, who, however, was not an officer of the company.

Between May 12th, 1924, and July 28th, 1925, Petroleum Company drew thirty-nine checks on the bank, and Fulton forged the payee's endorsements on thirty-five of these checks, raised twenty-two, and changed the name of the payee, substituting the name of another, in nine, forging the endorsements of substituted payee in said nine checks. These checks were all paid by the bank upon presentment, and thirty-one of them, aggregating $3,650.95, were presented by and paid to other continuing solvent banks, and bore their endorsements. On August 7th, 1925, the frauds of Fulton were discovered, and

shortly thereafter reported to surety company, and an audit of the books of Petroleum Company was begun, at which a representative of surety company was present.

All of the thirty-nine checks in question were prepared for signature of the drawer by Fulton, and were completed in writing by him before signature except that the line for the application of the protectograph was left blank, and they were signed before the application of the protectograph to them. Fulton was trusted to fill in the line stating the amount of the check with the protectograph, and was charged with the duty of delivering the checks to the payees named therein.

The bank furnished regular monthly statements to its said depositor, together with cancelled checks charged to its account during the month.

After receiving notice surety company denied liability to the bank upon the bond sued upon, and requested that the bank notify prior endorsers and call upon them for payment of the raised or forged checks.

The bank stated to surety company that if it would agree to pay bank's claim it would immediately, if surety company so desired, make prompt demand upon the endorsers of the checks, for the surety company, for payment of said checks by reason of their endorsements thereon (R. 61).

Thereafter, on January 14, 1926, bank made an entry upon its books recrediting the account of the depositor with the sum of $5,512.72, the amount which it had originally charged to it on account of the raised or forged checks, and on February 3, 1926, began this action to recover said sum of $5,512.72.

The case was tried in the United States District Court for the Eastern District of Kentucky upon the pleadings and a stipulation of facts, and resulted in judgment for the petitioner. Upon appeal the United States Circuit Court of Appeals for the Sixth Circuit reversed the judgment and afterwards denied a petition for rehearing.

ARGUMENT.

I.

Under the Law of Kentucky Which Governs this Contract of Insurance, and Generally, the Relation Between Bank and Depositor is that of Debtor and Creditor, and the Bank Paid Out Its Own Money on the Checks Raised or With Forged Endorsements.

The long established relation of a bank to its depositor is that of debtor and creditor, and the money deposited in the bank is the property of the bank and the bank owes the depositor therefor. When a depositor draws a check on the bank the check constitutes his order on and authority to the bank to discharge this debt, *pro tanto*, by payment according to such order and authority. When the check is raised or an endorsement is forged it is no longer an order upon or authority to the bank to pay, and where the bank mistakenly, or even negligently, pays such check it is paying out its own money and not money which it is entitled to charge against its depositor as *pro tanto* payment of its debt to him.

In the case of Henderson Trust Company v. Ragan, 21 Ky. Law Rep. 601, 52 S. W. 848, the court said:

"The rule is well settled that, if a bank pays a check on a forged endorsement, it must sustain the loss. Tied. Com. Paper, par. 449. Where money is paid upon a pretended, not a real endorsement of the name of the payee, in law, the check remains unpaid and can not diminish the funds of the borrower in the bank or the money in the pocket of the person entitled to the payment. Bank v. Whitman, 94 U. S. 347."

In Rice v. Citizens National Bank, 21 Ky. Law Rep. 346, 51 S. W. 45, the court said:

"A deposit in bank of an ordinary deposit creates the relation of debtor and creditor. * * *. It is immaterial whether this deposit of $700.00 be treated as a general deposit or as a deposit for a special purpose other than bailment. The money was paid out precisely as the special instructions with the deposit provided, except that the signatures of the payees of the checks were forged. The principle seems to be well settled that a payment by a bank of a check to any person save the payee himself, except it be payable to bearer, is a payment at its peril. If the signature of endorsement is genuine, it is a payment out of the depositor's fund; if it is forged it is a payment out of the bank's funds and the depositor can not be charged with it. Shipman v. Bank (N. Y. App.), 27 N. E. 371; Hatton v. Holmes (Cal.), 31 Pac. 1131; Bank v. Whitman, 94 U. S. 347; Bank v. Morgan, 117 U. S. 112; Bank v. Burke (Ga.), 8 S. E. 739, and many other cases * * *. We conclude that the bank is liable to appellants for this deposit. The payment on a forged check was a payment by appellee at its peril. It was not a payment of appellant's funds, however great the care used by the appellee. It is not a question of care or negligence. The pay-

ment was not to the payee of checks but a payment on what purported to be his order. The order (endorsement on the check) was a forgery. For this payment appellants are in no way liable. There was no relation of principal and agent between the appellants and appellee. It was pure debtor and creditor."

To the same effect is the case of Leather Manufacturers National Bank v. Morgan, 117 U. S. 96, 29 L. Ed. 811.

The opinion of the Circuit Court of Appeals in this case states the rule as follows:

> "The relation between banker and depositor is that of debtor and creditor. The money with which the check is paid is the money of the bank. Its contract with the depositor only entitles it to charge back to, and collect from, the depositor the amount of a valid check so paid. When it pays a forged check it has no right to make this counter-charge, and its loss continues to be its loss."

II.

The Loss Covered by the Bond was the Loss of the Bank's Own Money Paid on the Checks, Raised or With Forged Endorsements, and this Loss was Sustained When Such Checks Were Paid, Irrespective of Any Possible Right of Recoupment, in Special Cases, by Future Implied Ratification by the Depositor, Estoppel of the Depositor to Assert the Forgery, or Recourse Upon Responsible Endorsers to Whom the Money Thereon Has Been Paid.

The real question for decision in this case is whether the loss covered by the bond is that sus-

tained by the bank as and when the various checks, raised or with forged endorsements, were paid. We submit that the loss against which the bank contracted for protection is a loss of its own money which it mistakenly or negligently pays on raised checks or those with forged endorsements. The intent of the parties that the loss covered is incurred by the bank at the time of payment is fortified by the fact that the deposits of a bank are payable on demand, and that the bank is under a necessity of maintaining its deposit fund unimpaired. When its deposit fund is depleted by a mistaken payment of forged checks it is essential that it be restored immediately upon learning of the loss, and such restoration it provides by its contract of insurance. The bond or contract of insurance sued on herein requires a written notice as soon as possible after the bank learns of the loss, the filing of itemized proof of claim within ninety days, and limits action on the policy to one year after learning of the loss. This clearly contemplates that the loss covered by the bond occurs at the time of payment of the checks.

In the case of Fitchburg Savings Bank v. Massachusetts Bonding & Insurance Company, 174 N. E. 324 (Mass. 1931), a question very similar to the one presented here arose. The suit was upon a "banker's blanket bond." By certain methods we need not relate the Treasurer of the insured bank, through his fraud and dishonesty, abstracted from the bank about $50,000.00, and the bank in the transaction received several notes with endorsers thereon. The surety company contended that the loss covered by the bond was the net amount irrecoverable after all rights against others than the surety company had been exhausted. The court said:

> "In this bond the word 'loss' means the deprivation or dispossession of money or property of the bank due to the dishonest criminal or fraudulent acts of its officers; regardless of the security the bank has for the loss, and that the 'loss' occurred and was suffered by the plaintiff, without regard to its possible remedies, when its funds in fact were diverted on October 8, and 10, 1925, through the fraud and dishonesty of its treasurer. Forbes v. Manufacturers' Ins. Co., 1 Gray 371; Queenan v. Palmer, 117 Ill. 62, 619, 629, 7 N. E. 470, 613; Mitchell Grain & Supply Co. v. Maryland Casualty Co., 108 Kan. 379, 384, 195 P. 978, 16 A. L. R. 1488; First National Bank of Crandon v. United States Fidelity & Guaranty Co., 150 Wis. 601, 607, 137 N. W. 742; American Surety Co. of New York v. Lawrenceville Cement Co. (C. C.) 96 F. 25, 30; Champion Ice Manuf. & Cold Storage Co. v. American Bonding & Trust Co., 115 Ky. 863, 874, 75 S. W. 197, 103 Am. St. Rep. 356."

In construing the language of the bond so as to thus define the loss covered thereby, the Court said:

> "The evidence would not warrant a finding that the plaintiff had exhausted every remedy it has against Nichols and the indorsers on the notes. It is, therefore, the contention of the defendant that the plaintiff has sustained no loss, or if it has, that it can recover nominal damages only.
>
> "A definition of the loss for which the defendant as surety is liable as the net amount irrecoverable after all rights against others than the surety have been exhausted clashes with several sections of the bond. Section 6 provides that '* * * the Underwriters upon payment of any loss hereunder shall become subrogated to

all the rights and remedies of the Insured in respect of such loss.' Section 9 provides: 'At the earliest practicable moment, and at all events not later than ten days, after the Insured shall discover any loss hereunder, the Insured shall give the Underwriter notice thereof by registered letter or telegram. * * * Legal proceedings for recovery of loss hereunder shall not be brought * * * after the expiration of twelve months from the discovery of such loss. If any limitation embodied in this paragraph is prohibited by any law controlling the construction hereof, such limitation shall be deemed to be amended so as to be equal to the minimum period of limitation permitted by such law.' Under the provisions of the contract it is obvious that the definition of 'loss' suggested by the defendant as the measure of its liability under its contract with the plaintiff might result in denying the insured a remedy altogether through its inability to exhaust its rights against third persons within the limitations of time allowed in the bond for bringing actions against the defendant. It is plain such a result unless absolutely required should not be held to express the intention of the parties. American Surety Co. v. Pauly, 170 U. S. 133, 144, 18 S. Ct. 552, 42 L. Ed. 977."

In the light of the above decision, an examination of the terms of the bond involved in the present case discloses that the loss insured against is that which arose when the checks were paid "regardless of the security the bank has for the loss and * * * without regard to its possible remedies."

In addition to the provisions requiring the insured to give written notice of any loss as soon as possible after learning thereof, and to file an itemized sworn proof of claim within ninety days after learning of such loss, and that no action should be brought under

the bond in regard to any loss unless begun within twelve months after the insured shall learn of such loss, the bond gives the surety company the right to terminate it by thirty days' written notice to the insured. If the construction of the bond contended for by the petitioner is correct, that the loss covered by the bond does not arise upon the payment of the forged check but upon an adjudication of liability of the bank to the depositor, and upon payment to the depositor of this adjudged liability, then the surety company could well cancel the bond after knowledge of the payments upon the forged checks, and before a repayment or recredit to the depositor occurred, and then contend that the loss occurred after the termination of the policy.

Should a bank omit notice to the insurer when it first learns of the mistaken payment of its money upon forged checks, and only give notice after it had learned, as the result of protracted litigation with a depositor or endorser, that it could not recover from them, it is certain that the surety company would contend, and the court hold, that the notice was too late and that the loss had occurred when it first made the payment and not when it was finally determined that the bank had irrecoverably lost money by such payment. The bond does not contemplate any such vague and uncertain time for learning of the loss and giving notice. It clearly contemplates that the loss occurred at the time of payment.

The only provision in the bond involved in the Fitchburg Savings Bank case, cited *supra,* of those referred to by the court as supporting its conclusion that the loss covered by the bond occurred when the bank's funds were diverted and paid out, with-

out regard to the security the bank has or its possible remedies, which is not found in substance in the bond in the present case, is that which provides that the insurer shall, upon payment of any loss, be subrogated to the rights and remedies of the insured without respect to such loss. The absence of such a provision is not material, because, as a matter of law, the insurer has such right. On this point the Circuit Court of Appeals said;

> "If the Surety Company could get the benefit of any rights the bank had to recover its loss, or part of it, from others, it would be by paying the loss and acquiring these rights through subrogation. (Travellers Co. v. Great Lakes Co., —C. C. A. 6,—184 Fed. 426, 430; U. S. Fidelity Co. v. Union Bank,—C. C. A. 6—228 Fed. 448, 452). The Surety Co. was doubtless entitled itself to give the necessary notices. Its request to the bank to do so was not in connection with any offer to pay up its liability, so that it might be entitled to have them given for it; the request was in connection with a denial of all liability."

In Sprague v. West Hudson County Trust Co., *et al.*, 92 N. J. Eq. 639, 114 Atl. 344, it appears that a party who had endorsed checks to which a prior endorsement was forged, filed an action against the banks on which the checks were drawn and which had paid them, and against the drawer of said checks, to restrain the defendant banks from repaying or recrediting to its said depositor the amount of such checks paid by the banks on forged endorsements, until a court of competent jurisdiction had determined that the banks were legally liable thereon. The basis for this action was that the depositor had

been negligent in the examination of its vouchers and bank statements, and the relief prayed for was that the banks be restrained from repaying to the depositor the amounts of the checks paid by them on forged endorsements "until a court of competent jurisdiction has determined that said defendant banks are legally liable thereon".

The court denied the relief sought and said that there was no equity in favor of the complainants; that the duty of the depositor to exercise reasonable diligence in examining the vouchers and bank statements was a duty it owed to the banks, "but we have never heard that this duty extended to others than the bank".

This case is helpful as showing that the bank's loss through payment of the checks with forged endorsements was sustained at the time of payment and created an immediate right to look to the endorsers for reimbursement without first litigating with the depositor the question whether the depositor was estopped and whether the checks were in fact chargeable to the account of the depositor.

The above case was followed and quoted with approval in First National Bank of Jersey City, for use of National Surety Company v. Merchants Trust Company, 140 Atl. 582 (N. J. 1927). The National Surety Company, having guaranteed the plaintiff bank against loss by reason of the payment of checks with forged endorsements, paid to said bank its loss by reason of paying such checks, and the bank, for the use of the surety company, filed suit against the defendant bank, which by its endorsements had guaranteed all endorsements prior to its own. There were 14 checks between August 10th, 1925, and February 1, 1926.

The defendant answered that the loss of the plaintiff bank was sustained through the negligence of the depositor to use reasonable diligence and care to discover the fraud, and that the plaintiff was reimbursed its loss by the depositor (we assume by permitting checks to be charged to depositor's account, without objection, for several months). The defendant undertook to have the depositor and the insurance company made parties plaintiff or defendant. The court refused to do this, and quoted with approval from the case of Sprague v. West Hudson County Trust Company, *supra,* in part as follows:

> "When the bank has paid on a forged endorsement it must ordinarily make good to its depositor, and then stands, as to all endorsements below that of the forger, as a holder in due course. In the present case the writers of the endorsement immediately below the forged one are seeking to intrude into the relation between the bank and its depositor by requiring the bank, for their benefit, to defend against the depositor's claim. This defense, in our opinion, is for the bank alone, and parties claiming under the payee have no right to require the bank to set it up."

The court also held that the liability of the defendant by reason of its endorsement must be tested by its contract with the plaintiff, and to that issue the surety company was neither a necessary nor proper party.

The above case illustrates that the surety company involved therein construed its bond as covering the loss which arose upon the payment of the checks, and it paid this loss to the bank on this theory, and itself sought recovery from the endorsers through

suit by the bank in its behalf. This the petitioner herein could have done and ought to have done.

In Royal Indemnity Company v. American Vitrified Products Company, 158 N. E. (Ohio) 827, a bond covering pecuniary loss of money sustained by fraud, including forgery, was executed by the appellant. Certain defalcations occurred after the execution of the bond and during its term by which prior defalcations were made good. It was held that the loss occurred when the money was originally taken and that the bond did not cover it, and the court said:

> "The form of paying one customer's account out of the money collected from another customer did not change the amount of the loss, for such loss already existed."

In Kimbell Trust & Savings Bank v. Hartford Accident & Indemnity Co., 333 Ill. 318, 164 N. E. 661, the bond insured a bank against loss by reason of having taken as collateral any forged security. Prior to the term of the bond the bank took as collateral security, to secure a note, certain forged bonds. The original note was renewed and marked paid, and subsequently there were two like renewals, the collateral remaining with the bank. It was held that the bond did not cover the loss of the bank by reason of the taking of the forged securities, as the taking occurred prior to the term of the bond.

In the case of Royal Indemnity Company v. North Texas National Bank, 25 S. W. (2nd) 822 (Texas), the bond covered loss through dishonest or criminal acts of officers, and bank's teller embezzled certain monies during the term of the bond. These embezzlements were concealed by the teller temporarily sub-

sequently withholding deposit slips and taking the money deposited to cover up and conceal the amount of the embezzlements he had already committed. The next day he would repeat the transaction by placing the deposit slip withheld by him on the previous day with the records of the bank and then withholding others in the same manner. Such transactions continued for several years.

The court held that the loss occurred within the meaning of the bond, at the time the money was actually abstracted, although the books of the bank showed no loss until after the term of the bond had expired.

III.

The Bank Was Not Required to Attempt Recoupment of Its Loss Sustained Through and at the Time of Payment of the Checks Before Proceeding Against the Insurer.

Without again quoting therefrom the case of Fitchburg Savings Bank v. Massachusetts Bonding and Insurance Company, cited *supra,* establishes that the insured need not attempt to recoup its loss before suing upon the bond and obtaining judgment against the surety company.

Under the law of Kentucky which controls this contract of insurance this rule is firmly established.

In Champion Ice Manufacturing Co. v. American Bonding Co., 115 Ky. 863, 75 S. W. 200, the court said:

> "It would be restricting the law of both insurance and suretyship to an absurd degree to say that appellee cannot be held liable until after appellant, having exhausted every other remedy or

prosecuted to insolvency any others who might be liable, is still not reimbursed. In other words, appellee's liability does not depend upon whether appellant might collect the stolen $500, from some one else. Having a right of action against the defaulter, Weitkamp, appellant has also the right of action against the guarantor of his honesty."

25 Corpus Juris 1111, reads as follows:

"A fidelity bond, indemnifying against dishonesty, is essentially an insurance contract, guaranteeing the payment, and not a mere guarantee of collection, upon which the insured can recover only after exhausting his remedies against those primarily liable."

In First National Bank v. U. S. Fidelity and Guaranty Company, 137 N. W. 744, the Court said:

"If the plaintiff were required to exhaust its remedies against Price and Eidsmoe before it could have recourse against the defendants, it might well be that it could not comply with the conditions of the bond at all, because it might not be able to enforce its remedies against these parties within the time which the bond attempts to limit for commencement of suit thereon. It appears to be quite clear that the language of the bond gives the plaintiff an absolute right to recover its loss from the surety as soon as it occurs, and not the qualified one to recover only so much of the loss as cannot be recovered from those responsible for it."

In National Surety Company v. Sheridan County, Mont., 33 Fed. (2nd) 473, the bond insured the County and its Treasurer against loss by robbery. Certain bonds of the County and County warrants were taken by robbery and the surety company contended that the bonds and warrants were non-negotiable and that the County could protect itself by refusing payment of them if presented. The Court held that the county bonds were negotiable, and with reference to the warrants said:

> "The power of the county to protect itself in case they fall into the hands of innocent purchasers is doubtful, and in any view the assured and the county are by the robbery subjected to the hazard of litigation and the expense incident thereto, and we see no way by which they can be given adequate protection against a loss which is prima facie the value of the warrants. Upon paying the loss, the appellant would be subrogated to the rights of the owners of the stolen securities, and may, by giving security and otherwise pursuing the course provided by the state statute, procure duplicates thereof and collect thereon at their maturity."

The case of First National Bank of New Jersey, etc., for use of National Surety Company v. Merchants Trust Company, cited *supra,* shows that the surety company assumed the burden of recouping the loss by paying same to the insured and filing suit in the name of the insured.

IV.

Assuming, Yet Denying, that the Loss Covered by The Bond Was Sustained by the Bank Upon the Recredit to the Depositor's Account, this Does Not Defeat Recovery in this Action as a Legal Adjudication of the Bank's Liability is Not Required.

The case of Ocean Accident & Guaranty Corporation v. Old National Bank, 4 Fed. (2nd) 753, is conclusive that the insured may recover without adjudication of its liability, as in this case, to the depositor.

In Globe Indemnity Company v. Union & Planters Bank and Trust Company, 27 Fed. (2nd) 496, (C. C. A. 6th) the Bank was indemnified against loss through misconduct of its Vice-President, who personally sold negotiable paper to other banks and agreed, within the apparent scope of his authority, that his bank would repurchase such paper when requested. It was held that no previous adjudication of the plaintiff's liability to repurchase was necessary in order to recover from the surety for the loss arising through the repurchase.

V.

The Petitioner Has Not Shown in this Record that the Recredit to the Depositor's Account Was Voluntary,—that is that the Bank Was Not Legally Liable to Make Such a Recredit—Because (a) a Depositor is Under No Duty to Examine Endorsements on Cancelled Checks for Forgery, It Has a Right to Assume that the Bank Has Ascertained the Genuineness Thereof; (b) Knowledge of the Depositor's Agent, and Officer, Committing the Fraud, is not Attributable to the Depositor; (c) Though the Depositor is Negligent in the Examination of the Cancelled Checks the Bank Must Be Free of Negligence in Paying them to Defeat Liability to the Depositor; (d) the Burden is Upon One Asserting Non-Liability of the Bank to the Depositor to Show that the Bank Was Not Negligent in the Payment of the Checks, and (e) the Delay of the Depositor in Discovering the Forgery Must Be Shown to Have Prejudiced the Bank.

Assuming, but not admitting, that the loss to the bank occurred when the recredit was made to the depositor's account, the surety company must establish that the bank was not legally liable to make such a recredit. The District Court overruled a demurrer to the petition showing the payment of the checks and the subsequent recredit, and the burden was therefore on the surety company by answer to affirmatively show that the recredit was not justified even under its theory of this case. This the surety company has failed to do because (a) the depositor is under no duty to examine endorsements on cancelled

checks for forgery, but has a right to assume that the bank has ascertained the genuineness thereof.

The case of Leather Manufacturers National Bank v. Morgan, cited *supra*, relied upon by the petitioner, was not a case of forged endorsements but of alteration of checks by raising the amount, and is not in conflict with the following cases supporting the rule stated, to-wit: National City Bank of Chicago v. Third National Bank of Louisville, Kentucky, 177 Fed. 136 (at page 140); Jordan-Marsh Company v. National Shawmut Bank, 201 Mass. 397, 87 N. E. 740, 22 L. R. A. (N. S.) 250; Welsh v. German American Bank, 73 N. Y. 424, 29 Amer. Rep. 175; Shipman v. Bank of State, 126 N. Y. 318, 27 N. E. 373, 12 L. R. A. 791; Annotations, 67 A. L. R. at page 1125, 15 A. L. R. 166.

In City of St. Paul v. Merchants National Bank, 187 N. W. 516 (Minn.), 22 A. L. R. 1221, the Court said:

> "The bank's obligation is to pay the checks only upon a genuine indorsement. The drawer is not presumed to know, and in fact seldom does know, the signature of the payee. The bank must, at its own peril, determine that question. It has the opportunity, by requiring identification when the check is presented, or a responsible guaranty from the party presenting it, of ascertaining whether the indorsement is genuine or not. When it returns the check to the depositor, as evidence of a payment made by its direction, the latter has the right to assume that the bank has ascertained the fact to be that the indorsement is genuine."

(b) The knowledge of Fulton, the forger, is not attributable to Petroleum Company, the depositor, and

notice to the depositor's said agent and officer, who has a hostile personal interest in the transaction, is not notice to the depositor of the forgeries and alterations. American Surety Company v. Pauly, 170 U. S. 133.

(c) Though the depositor is negligent in the examination of cancelled checks and bank statements, the bank must be free of negligence in the payment of such checks to defeat liability to the depositor. This rule is recognized in the Leather Manufacturers Bank case, *supra,* in which the Court said:

> "Of course, if the defendant's officers, before paying the altered checks, could by proper care and skill have detected the forgeries, then it cannot receive a credit for the amount of those checks, even if the depositor omitted all examination of his account."

Other cases to the same effect are Union Tool Co. v. Farmers & M. National Bank, 192 Calif. 40, 218 Pac. 424, 28 A. L. R. 1417; Coleman Drilling Company v. First National Bank, 252 S. W. 215; Glossel Development Company v. Citizens National Bank, 191 Calif. 375, 216 Pac. 1012, 28 A. L. R. 1427; U. S. v. National Bank of Commerce, 205 Fed. 433, 7 C. J. 688; Critten v. Chemical National Bank, 171 N. Y. 219, 63 N. E. 969, 57 L. R. A. 529.

This record shows that the names of the payee in nine of the checks had been erased and other names substituted therefor before the checks were presented to the bank for payment, also that several of the checks had the forged endorsement of Felix M. Miles, who was president of the depositor and authorized to sign checks and the bank no doubt was familiar with

his signature from the signature card, and the bank paid one of such checks on October 4, 1924, near the beginning of the fraudulent transactions.

It was held in Critten v. Chemical National Bank, *supra,* that the bank was responsible to the depositor in spite of the depositor's negligence in examining the cancelled checks, for all checks paid by the bank subsequent to the negligent payment of a certain check and the Court said:

> "That the defendant was grossly negligent in paying the check, and has only itself to thank for that loss, is apparent. But the effect of that negligence did not cease with the payment of the check. The referee might well have found that, had payment of the check been refused, or had Davis been required to obtain the indorsement or guaranty of the plaintiffs as to its correctness, the forgeries of Davis would have been exposed, and their repetition would not have occurred. That Davis was able to successfully continue from the time to his arrest a series of forgeries is as fairly attributable to the folly of the bank in paying to a clerk a check of his employers which had plainly been altered, without making inquiry as to the reason or authority for the alteration, as it was to any carelessness of the plaintiffs in failing to detect the alteration when the checks were returned to them from the bank. Since we have held that the question in the case was not one of ratification or estoppel, but that the liability of the plaintiffs to the bank was solely for the loss caused by their negligence, it is a complete answer to the defendant's claim that its own negligence contributed to the loss."

(d) The burden is upon the surety company which is asserting herein the non-liability of the bank to its

depositor, to show that the bank was not negligent in the payment of the checks. It is not sufficient for the surety company to plead and prove that the depositor was negligent in the examination of cancelled checks and in failing to discover the alterations and forgeries, it must further plead and prove that the bank was free of negligence in the payment of the checks.

In the case of Wussow v. Badger State Bank of Milwaukee, 234 N. W. 720 (Wis.—1931) the Court, after stating that it was the duty of depositor to examine his checks and statements said:

> "But it does not follow that the depositor cannot recover if the bank was itself negligent. The bank's exemption from liability in such case is dependent on its own freedom from negligence. Hamerschlag Mfg. Co. v. Bank, (C. C. A.) 262 F. 266, 271; Leather Mfgrs. Bank v. Morgan, *supra,* page 112 of 117 U. S., 6 S. Ct. 657. In the cases holding the bank exempt from liability because of the plaintiff's negligence it affirmatively appears that the bank was not negligent or the question of its negligence was not raised. If due care on the bank's part would have discovered the forgeries without the aid of the plaintiff, the bank cannot then escape its contractual liability merely because the plaintiff was also negligent. In such case the bank does not pay because previous forgeries were not reported to it. It pays because on its own negligent inspection it supposed the checks were genuine."

The Court placed upon the defendant bank the burden of proving that it was free from negligence, and in response to the argument that the burden was on the depositor to show that the bank was negligent, the Court said:

"The defendant contends that the court erred in placing upon the defendant the burden of proving that it was free from negligence. It urges that as the burden was on the bank to show plaintiff's negligence to exempt it from liability, the burden was on the plaintiff to show that the bank was negligent to relieve him from the effects of his negligence by analogy to the rule in negligence cases where the plaintiff has the burden of showing negligence and the defendant the burden of showing contributory negligence. There are cases involving recovery of unauthorized payments by banks which speak of negligence of the plaintiff and contributory negligence of the bank. But the situations are hardly analogous. The bank's claim in such cases is that the depositor is in equity estopped to assert that the bank is absolutely liable because the defendant's conduct has caused or contributed to the bank's payment of the forged check. But it is not unjust to require as a prerequisite condition to asserting such estoppel that the bank show that it was itself free from negligence. The right to assert an estoppel in equity does not arise unless the one asserting it has acted with due diligence. Due diligence being necessary to enable one to assert an estoppel, the bank must show due diligence before it can assert the negligence of the depositor. The whole doctrine of estoppel is a creation of equity and is governed by equitable principles. Pomeroy, Equity Juris, (4th Ed.) 813. The bank's freedom from negligence is treated as a 'preliminary question' in 3 Ruling Case Law, p. 539; National Dredging Co. v. Bank, *supra*, pages 607, 611, of 6 Pennewill, 69 A. 607. It is expressly held in Morgan v. The United States Mortgage & Trust Co., 208 N. Y. 218, 222, 101 N. E. 871, L. R. A. 1915D, 741, Ann. Cas. 1914D, 462, and Union Tool Co. v. Farmers, etc., Bank, 192 Cal. 40, 218 P. 424, 427, 28 A. L. R. 1417, that 'before a defendant bank will become en-

titled to escape its liability for payment of a forged check it must be shown that the bank itself was free from negligence,' notwithstanding that in California and in New York since 1920 as we infer, the burden of proving contributory negligence in negligence cases is on the defendant."

The case of Coleman Drilling Company v. First National Bank, *supra,* is to the same effect.

(e) The delay of the depositor in discovering the forgeries and alterations must be shown to have prejudiced the bank before the bank can escape liability for payment of the checks.

The Leather Manufacturers case, *supra,* apparently lays down the rule that prejudice to the bank will be conclusively presumed, but in that case the court authorized recovery upon the two checks last paid by the bank in the chain of forgeries, because the forgeries were discovered before the bank statement with these cancelled checks was delivered to the depositor. Under that rule regardless of all other questions the respondent bank was liable to the depositor for the checks paid during the month of July, 1925, amounting to $500.00.

Under Critten v. Chemical National Bank, *supra,* the depositor could recover from the bank for the checks paid during the first month of the payment on the forgeries and alterations. Applying this rule and regardless of any other question, respondent bank was liable to the depositor for $602.80, the amount paid by the bank during the month of June, 1924, the cancelled checks for which were returned to the depositor on or about July 1, 1924.

And many cases hold that the delay in discovering and reporting the forgeries and alterations will not

relieve the bank unless a loss or prejudice thereby is shown. Maryland Casualty Company v. Dickerson, 213 Ky. 305.

In U. S. v. National Exchange Bank of Providence, 214 U. S. 302, it is held that the right of recovery from a prior endorser of checks bearing forged endorsements is not conditioned on either demand or giving notice of the forgery. The federal rule seems to be established that irrespective of delay there is a right of recovery upon the warranty of genuineness of the endorsement which continues until barred by the Statute of Limitation. If this be the rule, the bank, as to checks aggregating $3650.95, was not prejudiced by the delay of the depositor in discovering the forgeries because solvent banks had endorsed these checks subsequent to the forged endorsements, and the respondent bank and the surety company, by subrogation, could have recovered from these endorsing banks the amount of said checks.

In National Surety Company v. Manhattan Company, 252 N. Y. 247, 169 N. E. 372, 67 A. L. R. 1113, the Court held that the failure of the depositor to discover the forgery and notify the bank may have impaired the bank's remedy against the forger, but in no wise affected its remedy against the guarantors, that is the endorsers subsequent to the forged endorsements, and said:

> "since it retains, unimpaired by any neglect of the depositor, an ample remedy, to obtain full reimbursement for the payments made, since, for these reasons, the bank has suffered no damage from the depositor's neglect therefore, the bank has no cause of action against the depositor, with which it may offset the damage incurred by him

through its unauthorized act in making the payments."

And the opinion further reads:

> "In our case, since the defendant the Manhattan Bank has a remedy over against its guarantor, the Bank of America, whereby it will be reimbursed for all the moneys which it has paid out upon the forged indorsements, we think it cannot justly maintain that it has been injured by the negligence of its depositor in delaying to report the forgeries after actual discovery thereof. Therefore the plaintiff should have a recovery in full for the unauthorized payments."

The above case has application to the $3,650.95 mentioned above.

The effect of the above cases is to show that there was a real and substantial controversy between the respondent bank and its depositor whose respective claims were held on each side in good faith, and which controversy, as stated in the opinion of the Circuit Court of Appeals "was capable of leading to tedious and expensive, if not doubtful, litigation", and we might add, to a loss to the bank which would not be covered by the bonds sued on herein.

And it must be remembered that this litigation would have been in the courts of Kentucky, and that the rule which would have been applied is laid down in the case of Commercial Bank v. Arden and Fraley, 177 Ky. 520, 197 S. W. 951, holding that under the Negotiable Instrument Law of Kentucky checks are made void by material alterations except to the extent of the amounts for which they were drawn, although in the hands of a bona fide holder in due course, and that the bank is liable to the depositor,

regardless of the depositor's negligence in the execution of the checks; and further, that the delivery of the cancelled checks to the depositor, without objection on his part, does not prevent recovery from the bank. Fidelity & Deposit Company of Maryland v. O'Brien, 180 Ky. 277, 202 S. W. 645, denying that it is the duty of the insured to attempt recoupment, would also have been applied.

VI.

The Bank Would Have Incurred a Hazard Not Covered by the Bond to Have Refused to Make the Recredit Demanded by the Depositor.

The charging of the checks to the depositor's account as they were paid by the bank constituted an attempt to recoup the loss sustained by the bank as the respective checks were paid. The recredit to the depositor's account was nothing but a book entry indicating the abandonment of the attempt to recoup the loss from the depositor. Had the bank refused to make this recredit the depositor could have drawn a check on the bank for the full amount of its deposit, including therein the amount originally charged by the bank upon the payment of the checks. If the bank had refused to pay this check it would have been responsible in damages to the depositor if it was ultimately determined that the surety company was mistaken in its position that the bank was not liable to the depositor.

In Berea Bank & Trust Company v. Mokwa, 194 Ky. 556, 239 S. W. 1044, the court held that an unintentional error on the part of the bank as to the amount of the depositor's account was no defense

in an action for damages by the depositor for the banks refusal to pay a check drawn upon it. A verdict for $750.00 against the bank was upheld by the court.

In Mt. Sterling National Bank v. Green, 99 Ky. 262, 35 S. W. 911, 32 L. R. A. 568; American National Bank v. Morey, 25 Ky. Law Rep. 2151, 80 S. W. 157, and National Bank of Lebanon v. Boles, 12 Ky. Law Rep. 422, the liability of a bank to the depositor for refusal to pay checks drawn by the depositor when there is sufficient funds to the credit of the depositor is recognized.

The loss or damage to the bank in such a case clearly would not have been covered by the bond, as it would have arisen not through payment of checks with forged endorsements, but upon account of the refusal of the bank to pay the depositor's check up to the amount of the deposit.

The bond by its terms does not require the bank to engage in litigation with the depositor, nor does it require the surety company to defend any action brought by the depositor arising out of the payment of forged or altered checks. The fact that the surety company, not obligated to do so under the terms of its bond, gratuitously offered to defend a suit by the depositor, can not enlarge upon the obligations of the bank under the terms of the bond, nor cast upon it the responsibility and hazard of becoming the defendant in litigation, the outcome of which was most uncertain.

In the cases of Transylvania Casualty Co. v. Williams, 209 Ky. 626; N. Y. Indemnity Co. v. Ewen, 221 Ky. 114, and Thatcher v. Aetna Co., 287 Fed. 484, cited by petitioner, the bonds were to indemnify

against loss resulting from "claims for damages", or "from the liability imposed by law upon the assured", on account of injuries inflicted by the automobile described in the policy. In the Thatcher case the policy of insurance expressly provided that the insured could not compromise any claim against him, and the other cases cited no doubt contained a similar provision although it does not appear in the opinions.

The bond herein did not require the surety company to defend for the bank the suit which it urged the bank to cause the depositor to bring against it, nor did it obligate the surety to pay the costs to the bank incurred by such litigation or any damages awarded to the depositor. Clearly the surety company had no right to refuse payment to the bank of the loss it had incurred when the checks were paid, and thrust the bank into expensive litigation which the surety company itself should have assumed by payment of the loss and suborgation to the rights of the bank. This right of subrogation, upon the payment of the loss to the bank, the surety company would have had. Litterdale v. Robinson, 12 Wheat 594, 6 L. Ed. 740; Travellers Co. v. Great Lakes Co., 184 Fed. 426; U. S. Fidelity Co. v. Union Bank, 228 Fed. 448.

CONCLUSION.

By reason of the payment of the checks raised or with forged endorsements, the bank had three remedies it could pursue to recoup its loss, one against the depositor, based upon estoppel of the depositor, one against the endorsers subsequent to the forged endorsement, and one against the surety company upon its bond, for which the bank had paid an adequate premium. The bank, in good faith, abandoned

its effort to recoup or recover from the depositor, and refused to look to the endorsers, all after the surety company had denied liability under the existing facts. We maintain that the bank acted within its rights and in accordance with the terms of the bond when it did so, and the judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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